Slaughter and May Podcast
Tax News Highlights: June 2023

Zoe Andrews	Welcome to the June 2023 edition of our tax news highlights podcast. I am Zoe Andrews, PSL Counsel & Head of Tax Knowledge.
Tanja Velling	And I am Tanja Velling, Tax PSL Counsel. In this podcast, we will discuss HMRC's updated guidance on the loan relationships unallowable purpose test and the first portion of its draft guidance on the multinational top-up tax, the Upper Tribunal's decision in *Hargreaves Property Holdings* and the Advocate General's opinion in the *Amazon* State aid case as well as developments in relation to the taxation of the oil and gas sector and the consultation on how to reform transfer pricing, permanent establishments and diverted profits tax legislation. And we are excited to be joined again by our colleague, Nele Dhondt, PSL Counsel in Competition to discuss the EU's Foreign Subsidies Regulation – although I suspect she might also have views on the Advocate General's opinion in *Amazon*! But before I hand over to Nele, I should note that this podcast was recorded on the 27th of June 2023 and reflects the law and guidance on that date. Now, Nele, in a nutshell, what is the EU's Foreign Subsidies Regulation?
Nele Dhondt	Thank you, Tanja. I'm delighted to be joining this edition to talk about the EU's new Foreign Subsidies Regulation, which entered into force on the 12th of January this year and will start to apply from the 12th of July. So, the Regulation gives the European Commission the power to investigate financial contributions granted by non-EU governments to companies active in the EU with the aim of preventing subsidies from outside the EU distorting competition within the EU. So, it's driven by the concern that, in recent years, foreign subsidies allegedly distorted the EU's internal market, including by providing their recipients with an unfair advantage to acquire companies or obtain public procurement contracts in the EU to the detriment of fair competition. So, the Regulation essentially aims to close a perceived regulatory gap whereby subsidies granted by non-EU governments go unchecked while subsidies granted by EU Member States are, of course, subject to close scrutiny under the EU State aid regime. Now, to achieve this level playing field, the Regulation contains notification obligations for M&A transactions and public procurement procedures that meet certain thresholds, allowing the EC to scrutinise these transactions and procedures and assess whether a foreign subsidy has distorted or distorts the internal market.

	But the EC can also request ad-hoc notifications for smaller transactions and procurement procedures and the Regulation gives the EC *ex officio* investigative powers where the EC suspects that there are distortive foreign subsidies. So there's broad powers for the EC here.
Zoe Andrews	And how is this regulation relevant to tax?
Nele Dhondt	Well, the relevance for tax becomes clear when we look at the definition of financial contributions in the Regulation. The definition is very broad and captures a wide range of contributions, including the transfer of funds or liabilities, which for example covers the usual capital injections, grants, loans, setting off of operating losses and debt forgiveness but it also includes fiscal incentives. And the financial contributions concept also encompasses the foregoing of revenue that is otherwise due, so, for example, tax exemptions. The EC's recently published Q&As, by the way, further explain how tax exemptions and tax holidays are considered for the purposes of the Regulation. And I should also mention that the concept of "third country" is also very broad in the Regulation because it refers to all levels of government and other foreign public entities and even private entities if their actions can be attributed to the third country.
Tanja Velling	That definitely sounds like a broad approach! Can you tell us a bit more about possible outcomes of an EC investigation? What happens, or could happen, if the EC finds that a distortive subsidy exists?
Nele Dhondt	Well, of course, yes, – where the EC finds that a distortive subsidy exists, the Regulation gives it the power to impose redressive measures, or accept commitments from the companies concerned, to remedy the distortion. These could include behavioural commitments or structural measures such as the divestment of assets. But the EC also has the power to eventually prohibit an acquisition or to prevent the award of a public contract to a subsidised bidder. So potentially far-reaching consequences!
Zoe Andrews	So, you mentioned that the Regulation will start to apply as of the 12th of July. Does this mean clients won't have to worry about it for any period before then?
Nele Dhondt	No. The Regulation will start to apply on the 12th of July this year, and the EC can then begin *ex officio* investigations, but the Regulation actually has retroactive effect in that it will apply to foreign subsidies granted in the 5 years prior to the 12th of July where the subsidies continue to distort the internal market after the 12th of July. And then, for notifiable concentrations and public procurement procedures this term is limited to three years and the notification obligations do not kick in until the 12th of October this year. But I should add that the EC has clarified in its Q&As that transactions that sign after the 12th of July and have not closed by the 12th of October will

	need to be notified (even though they have signed before the notification requirement kicks in on the 12th of October). So this basically means that companies who have received financial contributions from third countries should already be designing and implementing systems to collect information about contributions, and track, such contributions on an on-going basis, where possible of course using existing systems to minimise the significant administrative burden on the company. And they should also ideally collect evidence showing why significant financial contributions do not distort the internal market. This should then hopefully allow them to be in a good position to prepare notifications or respond to an *ex officio* investigation by the EC as and when these occur. But shall we move on to another EU development?
Zoe Andrews	Certainly! On the 8th of June, Advocate General Kokott delivered her opinion in the *Amazon* State aid case, concluding that the General Court's decision should be upheld; this had annulled the European Commission's decision that Luxembourg had granted illegal State aid to *Amazon* through a tax ruling in relation to royalty payments. Broadly, the EC had decided that the ruling constituted State aid because, in its opinion, the chosen pricing method was not in line with the OECD's Transfer Pricing Guidelines. The General Court annulled the decision on the basis that the EC had failed to demonstrate that the Guidelines had been misapplied so as to confer a selective advantage. But were the OECD's Transfer Pricing Guidelines even the correct reference system against which the ruling should be assessed?
Tanja Velling	This was one of the key points in Advocate General Kokott's opinion. The Commission had contended that, because Luxembourg and Amazon had not argued that the Commission had used an incorrect reference system, the Court of Justice could not examine this point. Advocate General Kokott disagreed. Luxembourg and Amazon had argued that the Commission had failed to demonstrate that there was a selective advantage, a necessary pre-condition for a finding of State aid, and determining the reference system is an integral part of determining whether there is a selective advantage. So, in deciding whether the Commission was right to find a selective advantage, the Court inevitably had to consider whether the Commission had used the correct reference system. And how is this determined? In *Fiat Chrysler*, the Court of Justice decided that, in direct tax cases, national law is the reference system. Materials such as the OECD's Transfer Pricing Guidelines form part of the reference system only to the extent that they have been incorporated into national law.

	Advocate General Kokott added to this that a "consistent administrative practice" of using those Guidelines in applying national law could also bring them into play as part of the reference system. But, importantly, the Commission would have to demonstrate in its decision that such a practice existed. It had failed to do so here – indeed, as Advocate General Kokott points out, it would have been impossible to show that there was an administrative practice in 2003 when Amazon applied for the ruling that the Luxembourg tax authorities referred to the 2010 and 2017 editions of the OECD's Transfer Pricing Guidelines. So, she concluded that the Commission had used an incorrect reference system, thus vitiating the decision for error of law.
Nele Dhond	In case the Court of Justice follows the Commission's argument that the Court was barred from considering the reference system itself, the Advocate General also considered whether, assuming the OECD's Transfer Pricing Guidelines as the reference system, the Commission's decision should stand. There are two related points I'd like to note in this respect. First, she considered that both, the determination of the reference system and the question whether it has been correctly applied, should be treated as questions of law subject to an appeal to the Court of Justice. She recognised that this could involve complex factual issues, and this should be reflected in the standard of review. And this brought the opinion back to the novel point raised in her opinion on the *Engie* State aid case, that the principles developed in the case law on aid schemes or general taxation should be transposed to cases where it is alleged that the law has been misapplied in favour of the taxpayer. So the result would be that a tax ruling could only be regarded as State aid where it is manifestly incorrect and therefore confers a selective advantage on the taxpayer. If the Court of Justice follows the Advocate General's opinion in these cases, this will or should significantly restrict the Commission's scope for challenging tax rulings on State aid grounds going forward. So, we'll see what happens.
Tanja Velling	Now, coming back to the UK, you will remember that the Spring Finance Bill abolishes the Office of Tax Simplification. Somewhat unsurprisingly to my mind, a report from the House of Commons Treasury Committee published on the 13th of June has concluded that this sends the wrong signal, namely that tax simplification is not a priority for the government – where it should be – because the report also concludes that the UK tax system is "overcomplicated" and this "creates compliance burdens, confusion and disincentives to work or grow a business." It recommends that, in the absence of a change of heart in respect of the OTS, the government should report annually to the Treasury Committee on steps taken towards simplification and offering a comparison of the complexity of the UK's tax system with those of different countries.

Zoe Andrews	It's actually quite ironic that, in the same Finance Bill legislating for the abolition of the OTS, we have 169 pages of incredibly complex rules on the multinational top-up tax and the domestic top-up tax. HMRC has issued partial draft guidance on the multinational top-up tax for comments until the 12th of September. It generally covers what I would describe as the easier parts of the legislation, including the scope of the rules and administrative provisions. We will have to wait for the next instalment of draft guidance for further information on the calculation of adjusted profits and covered taxes. The draft guidance contains some rather helpful worked examples as well as a derivations table – at paragraph 09990 – which references the parts of the Model Rules, Commentary and/or Administrative Guidance on which each section is based. This will make navigating the legislation in the context of the OECD / Inclusive Framework materials a lot more straightforward, especially given that the UK legislation often uses different defined terms from the Model Rules and does not necessarily follow the same order.
Tanja Velling	HMRC has also issued revised guidance on the loan relationships unallowable purpose test in the Corporate Finance Manual to set out its technical analysis of the legislation and provide examples of its practical application. The technical discussion reflects the approach taken by HMRC in recent cases and notes in a number of places that points are subject to ongoing litigation. The revised guidance states HMRC's view that the helpful comments of the then Economic Secretary on the introduction of the unallowable purpose test continue to be consistent with the law, even though other parts of the guidance would seem to apply an additional gloss to those comments. Where the Economic Secretary stated that, in general terms, financing to pay dividends would be unaffected, HMRC's related example of circumstances where the unallowable purpose test will not normally apply specifically assumes external (rather than intra-group) financing and that the dividend payment is required to "meet market expectations on returns". In general, the fact that the examples are very specific and heavily caveated will limit their usefulness. Particular caveats relate to reading across from examples or reading them together: "for instance, if the view is that the unallowable purpose [test] will not normally apply to each of two examples, it does not follow that there is automatically the same view in relation to the facts of those examples combined."
Zoe Andrews	Continuing with consultations, as part of Tax Administration and Maintenance Day on the 27th of April, we had been promised a consultation on the transfer pricing, DPT and permanent establishment legislation. We

	previously speculated that this would be published to give us reading material for the late May Bank Holiday weekend, but we then had to keep ourselves otherwise entertained. The consultation finally came out on the 19th of June and is open for comments until the 15th of August. HMRC will also hold four consultation events between the 27th of June and the 10th of July – the last date to register for the final two events is Friday, the 29th of June. One key principle underlying the proposals in relation to transfer pricing and permanent establishments is to align the UK's rules with OECD standards. The UK's transfer pricing rules are currently expressed as applicable with respect to a non-arm's length "provision" between two persons where the participation condition is met and the provision gives rise to a tax advantage for at least one of them. It is being considered whether references to "provision" should be amended to align the wording more closely with that of Article 9 (Associated Enterprises) of the OECD Model Convention which refers to "conditions [that] are made or imposed between the two enterprises in their commercial or financial relations". This would be to address a concern that "provision" might otherwise be interpreted too narrowly – despite the explicit requirement to interpret the domestic legislation in line with the OECD's Transfer Pricing Guidelines which essentially flesh out the requirements of the arm's length principle enshrined in Article 9.
Tanja Velling	I wonder whether this is part of a what seems to be a broader trend away from, or scepticism towards, what I might loosely call forms of conforming interpretation. Under the Retained EU Law (Revocation and Reform) Bill, the principle of conforming interpretation of UK with (retained) EU law would go, if it is enacted as proposed to remove the first three sub-sections of section 5 of the European Union (Withdrawal) Act 2018 and clarify that neither the principle of supremacy of EU law nor any other general principle of EU law is part of UK domestic law after the end of 2023. The Bill of Rights with which the government had proposed to replace the Human Rights Act 1998 would have done away with the obligation to interpret domestic legislation in a way that is compatible with the rights enshrined in the European Convention on Human Rights currently found in section 3 of the HRA. And finally, whilst clause 121 of the Finance Bill states that the purpose of the multinational top-up tax in Part 3 is to implement the income inclusion rule under Pillar Two, there is no provision for the legislation to be interpreted in line with the Model Rules, Commentary or Administrative Guidance. Instead, clause 262 allows the Treasury to amend the legislation

	by regulation to ensure consistency with Pillar Two. This regulation-making power is time limited; it cannot be exercised after 2026.
Zoe Andrews	But going back to the transfer pricing, DPT and permanent establishment consultation – I think we went off on a bit of tangent here – the government is also considering the removal of the participation condition, limiting the application of UK-to-UK transfer pricing, changes to the treatment of guarantees and a clarification of the interaction between the transfer pricing rules and valuation rules in the intangible fixed assets, loan relationships and derivative contracts regimes. As regards permanent establishments, the consultation moots updating the UK's domestic law definition to bring it in line with the most recent OECD Model Convention which would effectively expand the current definition of an agency permanent establishment (but the intention would be to retain the broker and investment manager exemption on current terms). The overarching proposal in respect of DPT is a merger with corporation tax. Instead of there being a separate tax, the government envisages the creation of a new assessment power available in the same circumstances – and which would also be at a higher rate.
Tanja Velling	The Energy (Oil and Gas) Profits Levy was introduced in mid-2022 as an additional 25% tax charge broadly on ring fence profits with some adjustments, taking the level of taxation of oil and gas profits within the scope of the levy up to 65%. As originally enacted, the levy was set to apply for the period from the 26th of May 2022 until the 31st of December 2025. The Finance Act 2023 amended the legislation to extend the duration of the levy until the end of March 2028 and increased the rate to 35%, bringing the level of taxation of oil and gas profits within the scope of the levy up to 75%. The rate at which investment expenditure is relieved was reduced to ensure that the cash value of the relief remained the same. The Spring Finance Bill pending before Parliament will make further changes to introduce a de-carbonisation allowance, and the government announced a further tweak on the 9th of June.
Zoe Andrews	Harking back to the original announcement of the levy on the 26th of May 2022, stating that, "if oil and gas prices return to historically more normal levels, [the levy] will be phased out", the Government announced an "Energy Security Investment Mechanism" pursuant to which the level of taxation will return to the pre-levy figure of 40% "if both average oil and gas prices fall to, or below, $71.40 per barrel for oil and £0.54 per therm for gas, for two consecutive quarters." According to the announcement, the thresholds have been calculated on the basis of 20-year historical averages.

Tanja Velling	The announcement has already been criticised for ostensibly focusing tax cuts on the oil and gas sector. But this would only be the case if the thresholds were met before the planned end date for the levy – which the government does not appear to expect. The announcement indicates that, on current forecasts, the change is not expected to impact levy receipts as the thresholds are not expected to be met before the planned end date. And it is entirely possible that whichever government is in office in March 2028 could come under pressure, in view of the prevailing political and economic headwinds, to continue with the levy in some form. So, whether this additional change to deliver on a promise made in the original announcement of the levy will help to restore confidence to foster investment or adds to the perception of a tax regime in flux remains to be seen. Alongside the statement, the government published terms of reference for a review of the fiscal regime with a view to encouraging investment in the UK's Continental Shelf, signalling a longer-term commitment to the sector.
Zoe Andrews	The Upper Tribunal decision in *Hargreaves Property Holdings* concerned assessments for interest withholding tax, with an aggregate amount of tax in dispute of just under £2.8 million. The taxpayer challenged the assessments on multiple grounds, including on the basis that the interest was not "yearly" and that, to the extent that it had been paid to a UK company, it was exempt from withholding tax under section 933 of the Income Tax Act 2007. As regards "yearly interest", the Upper Tribunal confirmed that the First-tier Tribunal had been entitled to look at the commercial substance and effect of the financing. Individual loans may have been short-term, but amounts repaid were almost inevitably readvanced and, overall, the intention was to provide longer-term funding. So, the interest was "yearly".
Tanja Velling	Under section 933, tax is not required to be withheld where "the person beneficially entitled to the income in respect of which the payment is made is a UK resident company". But what does "beneficially entitled" mean in these circumstances? The Upper Tribunal concluded that the term had to be construed purposively such that an entity which was interposed in the payment chain for no commercial reason other than to benefit from the exemption should not be regarded as "beneficially entitled" to the interest. It will be interesting to see how far this reasoning can be pushed; it has the possibility of introducing a significant amount of uncertainty into what one might have hitherto thought of as a bright-line, mechanical set of rules. If the case goes to the Court of Appeal, this is one point which would benefit from clarification. But what else do we have coming up?

Zoe Andrews	As Nele explained, the EU's Foreign Subsidies Regulation will start to apply from the 12th of July. In the UK, we will have L-Day on the 18th of July, when draft legislation for the next Finance Bill will be published (which feels rather soon given that the Spring Finance Bill has only just gone through the Commons). The draft legislation should include provisions on the reform of tax reliefs for research and development. Some of the consultations published on 27th of April 2023, as part of Tax Administration and Maintenance Day, are still open for comments, including those on changes to the construction industry scheme and HMRC's information and data-gathering powers both of which close on the 20th of July.
Tanja Velling	And that leaves me to thank you for listening. If you have any questions, please contact Zoe or me, or your usual Slaughter and May contact. Further insights from the Slaughter and May Tax department can be found on the European Tax Blog – www.europeantax.blog. And you can also follow us on Twitter – @SlaughterMayTax.